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SUBJECT: ITALY,S PARLIAMENT PASSES "SARBANES-OXLEY".

REF: A. 05 ROME 3195

¶B. 05 ROME 1043
¶C. 04 ROME 406

¶1. SUMMARY. On December 23 Italy's Senate passed the financial market oversight reform bill, two years after the massive Parmalat fraud scandal and just following the resignation of Bank of Italy (BOI) Governor Fazio. The bill leaves in place the five regulatory authorities: antitrust, central bank, securities market, insurance, and pension funds. The bill gives Italy's securities market regulator (CONSOB) the authorizty to raid firms suspected of securities violations, and to impound evidence. It also cuts the BOI Governor's term from a life-time appointment to six years, renewable once, and shifts the BOI's banking competition oversight to CONSOB and Italy's antitrust authority. The European Central Bank (ECB) has approved the reform.

¶2. Summary continued. The new law requires the affected regulatory agencies to write and implement a total of 35 new decrees and regulations in a period ranging from six to 18 months; CONSOB is responsible for 19. The new law integrates a law passed in April 2005 implementing the EU market abuse directive, strengthening the powers, and increasing the staffing of CONSOB. The bill also redefines a new category of crime called "Nocumento" or mega-fraud, which damages more than 0.1 percent of Italy's population (roughly 575,000 people) or, investment holdings investment holdings totaling 1.4 billion euro. Measures have already been taken to delay implementation of the new bill and some analysts believe that deputies passed the bill so they could campaign as anti-corruption reformers in the upcoming elections. Shifting authority among the five key regulators, the crush of implementing regulation, and the inevitable election-year slow down in administrative activity means it will be many months before the new law takes effect. END SUMMARY.

Two years of Political Disputes Wrap Up

¶3. On December 23 Italy's Parliament approved the last reform law of Italy's fragmented financial markets oversight system; capping the official, tough, and outrageously delayed GOI response to the 2003 Parmalat scandal. A watered down version of the original bill presented to Parliament by Finance Minister Giulio Tremonti in February 2004, the final package approved lacks the more aggressive steps proposed by Tremonti to protect private savings from corporate mismanagement, and to establish a single, consolidated financial regulatory authority to supervise banking and equity markets to pension and insurance plans, similar to the United Kingdom's Financial Services Agency. Tremonti's initial proposal appeared to have bipartisan support, but divisions between the government and the opposition quickly developed. The bill ran into trouble since Tremonti planned to clip the BOI's regulatory powers and impose a fixed term limit for the governor. Former BOI's Governor Fazio at the time had allies both within and outside the government coalition and as a result, the reform bill stalled.

Bank of Italy's New Role

¶4. The return of Tremonti as Finance Minister last fall (reftel A), following the resignation of Domenico Siniscalco, and the accusations of manipulation of bank mergers leveled against ex-Bank of Italy governor Fazio finally provided the necessary impetus to pass the market reform bill. Notably the bill sets a once renewable, six-year term for the new BOI Governor, and gives the antitrust authority more oversight over banking competition. The bill introduces more transparency and consensus in BOI's decision-making processes; before the reform authority at the BOI was held exclusively by the governor, who was able to make all decisions without transparency or a justification. The BOI

is also now required to report on its activities to Parliament every six months.

¶5. Under the new law the BOI governor is appointed by Italy's President, on the recommendation of the Prime Minister and the Finance Minister, who must first consult the BOI,s Superior Council, made up of thirteen members chosen by the BOI branches located capital of Italy's thirteen largest regions for five years. For this reason is currently made up of people chosen in the Fazio era. This new procedure was used for the appointment of the bank's new Governor, Mario Draghi. Previously the bank's Superior Council exercised significantly more discretion in selecting the new governor. Even within the restricted BOI board made up four members (the governor, the director general and two deputy directors general) that run the bank, Draghi is surrounded by people of the Fazio era. Any possible step toward the modernization of the BOI will pass through the expected retirement of the current DG and the appointment of a new DG coming from outside the bank.

¶6. BOI's capital, now controlled by the same private banks BOI regulates, will be transferred to public institutions by ¶2009. The total value of BOI owned by private banks is in dispute. The transfer of ownership to an as yet undefined &public institutions8 may lead to greater political influence over BOI's operations; however given that further details will be fleshed out in a new regulation it is difficult to speculate how this will unfold.

¶7. The BOI will retain its oversight of banking system stability, and will continue to investigate potential conflicts of interest cases between banks and non-banking companies. It will decide on a case by case basis the allowable level of indebtedness by a bank's controlling shareholders. The final version of the law eliminated a key provision to limit credit given by a bank to any one of its shareholders to three fourths of the value of the individual shareholders shares. This measure had been designed to discourage businesses from becoming bank shareholders to receive preferential, non-market-based credit.

¶8. General oversight for the banking industry, specifically monitoring anti-trust behavior and other non-competitive behavior, has been transferred from the Bank of Italy to the antitrust authority, under the direction of Antonio Catricala. One of the first consequences of the law was the announcement of an investigation by the antitrust authority on costs associated with checking accounts and ATM services.

Securities Market/Corporate Governance Authority Wins
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¶9. The new bill will strengthen the position of Italy's securities market and corporate governance authority, CONSOB, headed by Lamberto Cardia. CONSOB now has oversight of: 1) bond placement and circulation for bonds issued abroad by Italian companies or their foreign subsidiaries; 2) transparency in capital transactions, and 3) conflict of interest by senior management. For example, to issue bonds abroad, firms will now need to submit information to CONSOB. A firm's board of directors will be bound by CONSOB rules of conduct for stock capital transactions, and senior executives will be required to report any conflict of interest.

¶10. CONSOB will assume oversight of Italian companies and credit institutions operating with offshore financial institutions in tax havens. It will develop criteria by which Italian firms, listed on Milan's stock market, and financial institutions may retain authority over off-shore institutions. CONSOB will also regulate stock options and public company accounting oversight.

¶11. CONSOB's authority had already been strengthened by a bill signed into law in April 2005, which integrates an existing EU directive on market abuse into Italian law. The 2005 bill increases CONSOB's staff, from 450 employees to 600 employees, gives CONSOB greater investigative powers, and stiffens penalties for financial crimes to a maximum six years in prison. The bill also gives CONSOB access to the Centrale dei Rischi, the Central Bank archive of confidential accounting documents from financial institutions.

Of Note: Law Tidbits

¶12. The market reform law requires minority shareholder representation on a firm's board of directors. The bill confirms, but does not significantly change the powers of COVIP, Italy's supervisory body for pension funds, and for ISVAP, the supervisory body for private insurance, and creates a ministerial advisory commission on savings. This commission will consist of a President and two members, to be named by the Prime Minister based upon recommendations by the Ministers of Finance and Public Administration. COMMENT: The exact work this commission will is unclear, as its

mandate appears to duplicate activities of other market oversight institutions. END COMMENT.

¶13. The bill is also designed to reduce the power of Italy's banking foundations. In 2004, Italian banking foundations disbursed 1.2 billion euro, while in the period 1993/2004 they disbursed 7.3 billion euro. The total assets of Italian banking foundations or foundation of banking origin were equal to 41 billion euro at end-2004. Despite the banking reforms of the 90s, Italy's banking foundations remain powerful, wealthy, and private institutions, with members historically appointed by regional and local government authorities. For example, Fondazione Monti Paschi di Siena (MPS) owns 66% of MPS Bank, Italy's fifth largest bank, worth 6.7 billion euro at current market valuation. Regardless of a foundations share in a bank, the new bill limits a foundation,s voting to only 30 percent, reducing its control over board decisions, and indirectly encouraging the foundation diversify its investments, thus making the capital available to other parts of the economy.

¶14. The bill will allow financial market oversight authorities to request assistance from the Guardia di Finanza (GdF), Italy's financial police to conduct investigations. Although the regulatory authorities can currently request GdF assistance through a court order, this bill establishes new, direct links between the institutions and the GdF.

New Penalties for Financial Crimes

¶15. The bill provides weaker-than- anticipated regulation of fraudulent accounting practices. For example, the maximum prison sentence for falsifying corporate financial statements increased from one and half years to just two years. The political opposition had introduced a regulation increasing prison time to five years for fraudulent accounting practices; however the final version was considerably watered down. The new bill follows existing law in that no penalties apply to company directors and/or board members who prepare or disseminate fraudulent balance sheets when the discrepancies fall below five percent of a company's pre-tax profit.

¶16. The bill, creates (see reftel B and C) a new category of crime called "Nocumento8. Nocumento is defined as fraudulent accounting that adversely affects more than 0.1 percent of Italy's population (roughly 575,000 people)or investment holdings totaling 1.4 billion euro. This crime is punishable by a two-to-six year prison term.

Two Steps Forward, One Step Back

¶17. The new market reform bill was meant to be implemented January 12, 2006. However, a decree law postponing the implementation of some parts of the bill is now before Parliament, triggering a sixty day delay of the law's implementation. The decree, if approved, will: 1) postpone for an additional twelve months the enforcement of CONSOB's new regulatory powers, and 2) create a four-month transition period for the reform in the bond and insurance sectors. In addition the banking foundations have begun lobbying to postpone for twelve months the reduction in their maximum voting powers to 30 percent.

What Do the Changes Mean?

¶18. There still remain five market oversight authorities) the Antitrust Authority, the BOI, CONSOB, ISVAP, and COVIP, with a new, ill-defined ministerial level advisory committee on savings. The BOI remains overstaffed, with 8,000 employees, while CONSOB and the antitrust authority have significantly increased power, yet remain relatively understaffed.

Former Top Regulator Not Sanguine

¶19. Guido Rossi, university professor, jurist, and former president of CONSOB, has told the press that the new financial market oversight reform bill is one of the worst laws passed in the last thirty years. He said it was rushed through as part of a strategy to force former BOI Governor Antonio Fazio to resign. In addition, Rossi asserts, the bill was watered down under pressure by center-right party members in Parliament, perhaps in an effort to preserve the 2002 law that dismissed fraudulent accounting charges against Prime Minister Berlusconi for his dealing with SME, a former state-owned Italian food company. As a result of the 2002 law, judges suspended that criminal case against Berlusconi.

Oversight Authority Still Fractured/Overlapping
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¶20. While the new law may improve corporate governance in Italy, it leaves intact a fragmented regulatory structure with overlapping roles and confusing bureaucracy. Critics note the law was passed during at a time when of politicians facing re-election are anxious to show tough action against financial criminals.

As Always, Devil in the Detail -- Implementing Regs
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¶21. The bill requires several regulations to be first drafted and then implemented by the different regulatory authorities. So, the verdict remains out as to whether the law will achieve its original, long-awaited goal of overhauling and strengthening Italy's securities market and corporate governance oversight.
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